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Proposed statement of position : Accounting for real estate acquisition, development, and construction costs;Accounting for real estate acquisition, development, and construction costs; Exposure draft (American Institute of Certified Public Accountants), 1979, July 23

American Institute of Certified Public Accountants. Real Estate Accounting Committee

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR REAL ESTATE ACQUISITION, DEVELOPMENT, AND CONSTRUCTION COSTS

JULY 23, 1979

Prepared by the AICPA Real Estate Accounting Committee
For comment from persons interested in real estate accounting

Comments should be received by September 28, 1979 and addressed to Thomas W. McRae, Manager, Accounting Standards Division, File 4210 AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036

AICPA

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July 23, 1979

To interested parties:

An exposure draft of a proposed statement of position on accounting for real estate acquisition, development, and construction costs accompanies this letter. The exposure draft was prepared by the AICPA Committee on Real Estate Accounting.

The FASB has released for comment an exposure draft of a proposed FASB statement entitled Specialized Accounting and Reporting Principles and Practices in AICPA Industry Accounting Guides, Industry Audit Guides and Statements of Position: An Amendment of APB Opinion no. 20 that would designate specialized accounting and reporting principles and practices contained in enumerated AICPA guides and statements of position as generally accepted accounting principles and preferable accounting principles for purposes of applying APB Opinion no. 20, Accounting Changes. AICPA projects in process that the AICPA expects will result in the issuance of guides or statements of position within a year or less are addressed in the proposed FASB statement in paragraph 4, which states that "the Board plans to review any specialized principles and practices contained in those forthcoming AICPA documents before issuance and, if the Board finds them acceptable, it will announce in Interpretations of this [FASB] Statement that they are preferable accounting principles for purposes of applying APB Opinion no. 20."

The accompanying exposure draft is one of the projects that the FASB plans to review for designation by interpretation as preferable accounting principles for purposes of applying APB Opinion no. 20. To facilitate that review procedure, the accompanying exposure draft is being made available to those on the mailing lists of both the AICPA and the FASB. Your comments on this exposure draft of a proposed statement of position should be sent to Thomas W. McRae, Manager, Accounting Standards Division, File 4210, AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036.

Comments received by the AICPA will be considered by the FASB when it reviews the final statement of position on real estate costs to determine whether to designate as preferable the accounting principles and practices contained in that statement of position.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt
Chairman
Accounting Standards Executive Committee

Thomas W. McRae

Thomas W. McRae
Manager
Accounting Standards Division

PROPOSED STATEMENT OF POSITION ACCOUNTING FOR REAL ESTATE ACQUISITION, DEVELOPMENT, AND CONSTRUCTION COSTS

1. Recent trends in the real estate industry have produced dramatic increases in the size of enterprises, the cost of individual projects, and the time required to complete the development of individual projects. Those developments have focused attention on the need for guidance on accounting for costs associated with real estate acquisition, development, and construction. The accounting standards division of the American Institute of Certified Public Accountants has prepared this statement of position in response to that need.

SCOPE OF STATEMENT

2. The recommendations in this statement apply to accounting for real estate acquisition, development, and construction costs in financial statements that are intended to present financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles regardless of the nature of the entity involved, except as indicated in this paragraph. In providing guidance, the division believes that it is desirable to reduce, to the extent practicable, alternative practices in accounting for costs of real estate acquisition, development, and construction. This statement does not apply to transactions covered by the AICPA industry accounting guide, *Accounting for Retail Land Sales.* That guide applies to "retail lot sales on a volume basis with down payments that are less than those required to evaluate collectibility of casual sales of real estate." AICPA Statement of Position 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects,* should be followed in accounting for the costs and operations identified in that statement.

NATURE OF REAL ESTATE ACQUISITION, DEVELOPMENT, AND CONSTRUCTION ACTIVITIES

3. Real estate development and construction activities occur in four stages: (*a*) predevelopment, (*b*) development, (*c*) construction, and (*d*) sales or rental operations. Distinguishing between different stages or the beginning and end of some stages may often be difficult because similar costs may be incurred in different stages.

4. During the predevelopment stage, the purchaser investigates the property, negotiates for its acquisition, and finally enters into a formal contract to acquire the property. In addition to the agreed consideration, the purchaser incurs costs for related legal, recording, and title services. Costs also may be incurred for such things as appraisals, market feasibility studies, architectural and engineering services, soil tests, and zoning changes. Some of those costs may be incurred before there is a formal commitment to acquire the property.

5. Real estate builders and developers may acquire property well in advance of the beginning of construction and hold the property for an extended period while preparing development and building plans and obtaining zoning changes and other required permits. During that period costs are incurred for those activities and for such items as interest and property taxes.

6. On-site and off-site improvements, such as roads, sewers, utilities, grading, and site clearance, are made before the construction stage. Zoning approvals and building permits may require the developer to set aside land for community facilities (such as schools, parks, and roads) to be donated to local authorities or government units. Developers may be required to contribute funds to government units to help finance the construction of facilities, such as sewer plants and schools, to serve the property.

7. Real estate developers may receive revenue from, and incur costs for, incidental operations relating to real estate, such as operating temporary parking lot facilities or leasing undeveloped land for grazing or farming.

8. Real estate projects may include amenities, such as golf courses, tennis courts, indoor recreational facilities, parking facilities, and utility plants. Some amenities are sold to tenants' or homeowners' associations; others are intended to be self-supporting enterprises. Some or all of the costs of other amenities are expected to be recovered from lease or sale.

9. Differentiating between costs to be charged to expense and costs to be capitalized and associating capitalized costs with particular assets pose complex problems in accounting for real estate projects. Real estate projects generally require several accounting periods to complete. In addition, large real estate projects usually involve multiple purchases and sales that require complex cost accumulation and allocation techniques. Development and construction plans and costs and revenues are affected by factors such as market conditions, inflation, interest rates, zoning restrictions, terrain, and location. For example, a residence

next to a golf course or an office near the top of an office tower usually generates higher revenue than a similar unit otherwise situated.

PRESENT ACCOUNTING PRACTICES

Cost Capitalization

10. Cost capitalization practices vary widely. Some entities capitalize costs incurred before the acquisition of property, carrying costs, and indirect project costs. Others capitalize only some or none of those costs. An entity may have different capitalization practices for different projects or for different components of a particular project.

11. Accounting for revenues and expenses of amenities and incidental operations also varies: Some enterprises account for them as decreases or increases in capitalized costs, and others account for them in current operating results.

Allocation of Capitalized Costs

12. Real estate developers generally use one or more, including a combination, of the following methods to allocate capitalized costs: area, value, and specific identification. Under area methods, common costs are allocated to individual units based on the number of units or size, such as acreage or square footage. Under value methods, costs are allocated to individual units based on the relative value of the individual units. Under specific identification methods, costs identified with a specific property are assigned to that property. Common costs associated with the entire development, such as access roads, utility trunk lines, and amenities, usually are allocated by area and value methods.

THE DIVISION'S CONCLUSIONS

13. As a general rule, costs clearly associated with the acquisition, development, and construction of a real estate project should be capitalized. However, the division believes that preacquisition costs, carrying costs, indirect project costs, amenities, incidental operations, allocating capitalized costs to components of a real estate project, revisions of estimates, costs in excess of estimated net realizable value, abandonments and changes in use, and cost of sales should be accounted for in accordance with the recommendations in this statement.

Preacquisition Costs

14. Costs related to a property that are incurred before acquiring or obtaining an option to acquire the property should be deferred provided all the following conditions are met:

a. The costs are directly identifiable with the specific property.

b. The costs would be capitalized if the property were already acquired.

c. Acquisition of the property or of an option to acquire the property is probable. This condition requires, among other things, that the prospective purchaser is actively seeking to acquire the property and has the ability to finance the acquisition and that there is no indication that the property is not available for acquisition.

To the extent that any of the above conditions is not met, costs incurred before a property is acquired should be charged to expense as incurred.

15. The accumulated amount of deferred preacquisition costs (including option costs) should be charged (*a*) to capitalized project costs on acquisition of the property or (*b*) to expense when acquisition of the property is no longer probable. The amount of deferred preacquisition costs should be disclosed in the financial statements.

Carrying Costs

16. Generally accepted accounting principles have long permitted companies either to capitalize or charge to expense as incurred interest and other carrying costs, such as property taxes and insurance, incurred during the holding, development, and construction periods. Real estate carrying costs other than interest incurred during those periods should be capitalized.

17. The division is not now making a recommendation on whether interest should be capitalized as a carrying cost or charged to expense as incurred or, if capitalized, what method should be used or when capitalization should cease.[1]

Indirect Project Costs

18. Indirect project costs are indirect costs, such as accounting and legal fees and various office costs, that clearly relate to projects under development or construction. Some indirect project costs clearly relate to a specific project, such as costs associated with a field office at a project site and the administrative personnel that staff the office, and should be capitalized as a cost of that project. Other indirect project

[1] In Accounting Series Release no. 163 issued November 14, 1974, the SEC concluded that, with certain exceptions, companies that had not publicly disclosed an accounting policy of capitalizing interest as of June 21, 1974, would not be allowed to follow such a policy in financial statements filed with the commission, pending the establishment of standards by the Financial Accounting Standards Board (FASB). The FASB has issued an exposure draft (dated December 15, 1978) of a Proposed Financial Accounting Standard entitled *Capitalization of Interest Cost.* Accounting for interest costs related to acquisition, development, and construction of real estate will be required to follow the principles in that statement in the manner and at the time it is issued and becomes effective.

costs may relate to several projects and should be capitalized and allocated to the projects to which the costs relate in a rational manner based on the nature of activity that gave rise to the costs. To illustrate, for a computer department whose time is used 40 percent to compute payroll and maintain cost accounting records for projects under current development, 35 percent for managing operating properties, and 25 percent for the administration of the enterprise as a whole or for nonproject activities, 40 percent of the costs should be capitalized and allocated to the projects (for example, based on other project costs incurred during the period), and 60 percent should be charged to current expenses.

19. Indirect costs, including general and administrative costs, that do not clearly relate to projects under development or construction should be charged to expense as incurred.[2]

Amenities

20. Accounting for costs of amenities, such as golf courses, utility plants, clubhouses, swimming pools, and tennis courts, should be based on management's plans for the amenities. If amenities are to be sold or transferred in connection with the sale of individual units, costs in excess of anticipated proceeds, including expected future operating losses before the sale or transfer and net operating costs to be borne by the seller until they are assumed by buyers of units in a project, should be allocated as common costs since they are clearly associated with the development and sale of the project. If amenities are to be sold separately or retained by the developer, capitalizable costs in excess of estimated fair value of the amenities on the expected date of substantial physical completion should be allocated as common costs.[3] For the purpose of determining the amount of common costs, the fair value of an amenity should not be revised after the date of substantial physical completion of the amenity. As indicated in paragraph 24 of this statement, common costs should be allocated based on relative current market value (before construction) of each land parcel benefited. However, in allocating costs of amenities as common costs, land not expected to be developed in the reasonably near future should be excluded from the land parcels benefited.

21. Before an amenity is substantially completed and available for use, operating results of the amenity should be included as a reduction of or addition to common costs. When an amenity to be sold separately or held for investment is substantially completed and available for use, current operating income and expenses of the amenity should be included in current operating results, since the operations of the amenity no longer clearly relate to the development and sale of the project as a whole but rather to the objective of making a profit on operations or sale of the amenity itself.

22. The following assumed data are used to illustrate the application of the recommended accounting for the costs of amenities:

a. A single family residential project is to include a recreation center consisting of a swimming pool and tennis courts with an estimated cost of \$250,000.

b. The center is to be transferred to a homeowners' association in connection with the sale of the units in the project.

c. Each purchaser of a unit will be obligated to pay a monthly assessment fee.

d. The developer agrees to pay for operating losses before the expected date of transfer and the monthly assessment fees for all unsold units. Such support is estimated to be \$50,000.

Based on those assumptions, the total estimated cost of \$300,000 (the \$250,000 cost of the center plus \$50,000 in support costs to be paid by the developer) should be allocated as common costs based on the relative current market value of each lot benefited. However, the accounting would differ if the assumptions are modified as follows:

a. The center is to be retained by the developer.

b. Operating losses are estimated to be \$30,000 before substantial physical completion and \$20,000 after substantial physical completion.

c. The fair value of the center at the date of substantial physical completion is estimated to be \$200,000.

Under the modified assumptions, \$80,000, the excess of the cost of the center plus the estimated operating losses before substantial completion (\$250,000 plus \$30,000) over the estimated fair value at the date of substantial physical completion of \$200,000 should be allocated as common costs. Actual operating losses incurred after substantial physical completion should be included in current operating results.

Incidental Operations

23. An excess of incremental revenue over the incremental costs of incidental operations, such as operating temporary parking lot facilities or leasing undeveloped land for grazing or farming, should be accounted for as a reduction of capitalized project costs; an excess of incremental costs over incremen-

[2] Costs to sell and rent real estate projects should be accounted for in accordance with AICPA Statement of Position 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects.*

[3] The accounting for costs of amenities to be sold separately or retained by the developer recommended in this statement differs from the accounting under the AICPA Industry Accounting Guide, *Accounting for Retail Land Sales.* This statement does not apply to transactions to which that guide applies.

tal revenue should be charged to expense as incurred.

Allocating Capitalized Costs to the Components of a Real Estate Project

24. The costs of acquisition, development, and construction of real estate projects should be capitalized and assigned to individual components of the project based on specific identification to the extent practicable. All common costs, including the cost of land, should be allocated on the basis of the relative current market value (before construction) at the date of allocation to each land parcel benefited.[4]

25. A land parcel may be considered to be an individual lot or a phase defined for this purpose as a parcel on which units are to be constructed concurrently. It may be necessary to accumulate costs in one or more cost centers before final allocation if some costs apply to different portions of a project, for example, if some costs apply only to certain components of a project and other costs apply to other components or to the entire project.

26. Construction costs should be assigned to the individual units in a phase on the basis of specific identification if practicable. Otherwise, construction costs applicable to the phase should be allocated to individual units in the phase in a reasonable manner that achieves results comparable to allocation on the basis of the relative sales value of the individual units to the sales value of the total units in the phase.

27. For the purpose of illustrating the general principles, a developer is assumed to have under development a single family residential subdivision for which assigning costs to individual units by specific identification is impracticable. The smallest practicable unit for that purpose is a group of units to be constructed as a separate phase and sold individually. Based on those assumptions, the cost allocations might be as follows:

a. On-site and off-site costs specifically identified with the units in the phase would be allocated to the phase.

b. Common costs of the entire project (or a parcel) of which the phase is a part would be allocated to the phase on the basis of the relative current market value of the land in the phase (before construction) to that of the project (or parcel).

c. Costs allocated to the phase would be allocated to an individual unit on the basis of the relative sales value of the unit to that of all units in the phase. If a phase includes both units to be sold and units to be held for investment, the final allocation would be made to the investment units based on relative estimated fair value of the investment units to the total of the sales value of the units to be sold and the fair value of the investment units.

This illustration applies only to costs for which assignment to individual units on the basis of specific identification is not practicable. To the extent that it is practicable, those costs should be assigned to individual units on the basis of specific identification.

Revisions of Estimates

28. Estimates and cost allocations should be reviewed at the end of each financial reporting period. Costs should be revised and reallocated as necessary on the basis of current estimates. Effects of changes in estimates should be recorded prospectively in the current and future periods except as recommended in paragraph 29. To illustrate, for an increase in the estimate of *common costs* applicable to *future* sales that will result in profit margins lower than those recorded on previous sales from a project, profits recorded on prior sales should not be reduced retroactively. However, an increase in costs without comparable increases in market value can raise questions about whether the estimated total costs of property not yet sold exceed its net realizable value.[5]

29. When sales of real estate are recorded, it may be necessary to accrue certain estimated costs not yet incurred (see paragraph 33).[6] Changes in estimates of accrued costs applicable to sales revenue previously recognized should be recorded in operating results in the period in which the differences become known. To illustrate, the following circumstances are assumed: (*a*)sales of property were recorded in full in prior periods and did not require any deferral of revenue for future performance and (*b*) estimated costs of \$200,000 have been accrued relating to the sales revenue previously recorded. If current estimates of such costs are \$250,000, an additional \$50,000 should be accrued and charged to expense in the current period.

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[4] Under the AICPA industry accounting guide, *Accounting for Retail Land Sales*, other methods of allocating common costs (for example, the area method) that fairly match costs with related revenues may be used. This statement does not apply to transactions to which that guide applies.

[5] Adjustments of estimated costs to complete improvements and amenities of a project will not affect previously recorded deferred revenues applicable to future improvements and should not be charged to income of the period in which the need for adjustment becomes evident unless the adjusted total exceeds the applicable deferred revenue. If that occurs, the total anticipated loss should be charged to income in the period in which the need for adjustment becomes evident.

[6] If in accordance with paragraph 47 through 50, of the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*, a portion or all of the revenue for a sales transaction is deferred because the seller has an obligation for future performance, the costs related to the revenue should be recognized when the sales revenue is recognized.

Costs in Excess of Estimated Net Realizable Value

30. Costs associated with the development and construction of a property should continue to be capitalized in accordance with the accounting policies adopted even though capitalized costs of the property exceed its estimated net realizable value.[7] When the capitalized costs of real estate held for sale or for development and sale exceed its estimated net realizable value, an allowance should be provided to reduce the carrying amount to estimated net realizable value determined on the basis of an evaluation of individual projects. The evaluation should be reviewed at the end of each reporting period, and the allowance should be increased or decreased as necessary to maintain the carrying amount at the lower of cost and estimated net realizable value. An individual project for this purpose consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residential tract, individual units in a condominium complex, and individual lots in a lot subdivision). Therefore, a multiphase development consisting of a tract of single family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

Abandonments and Changes in Use

31. Real estate, including rights to real estate, may be abandoned, for example, by allowing a mortgage to be foreclosed or by allowing a purchase option to lapse. Capitalized costs, including allocated common costs, of real estate abandoned should be written off to current expenses and should not be allocated to other components of the project or to other projects even if other components or other projects are capable of absorbing the losses. Land donated to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the land donated should be allocated as a common cost of the project.

32. Changes in the use of real estate composing a project or a portion of a project may arise after significant development or construction costs have been incurred. In such circumstances, development and construction costs incurred before the change should be written off except as follows:

a. If the change is made pursuant to a formal plan for a "higher and better use," the write-off may be limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project at the date of substantial physical completion.

b. In the absence of a formal plan for a "higher and better use," the write-off may be limited to the amount by which total capitalized costs exceed the estimated net realizable value of the property determined on the assumption it will be sold in its present state.

To illustrate, the total capitalized costs of a golf course are assumed to be $1 million, including development and construction costs of $700,000 and land costs of $300,000. If, pursuant to a formal plan, the golf course is to be torn up in order to build single-family residences for sale, and such use would recover the capitalized costs of the golf course as well as the construction and development costs of the new project, the $1 million may be included in the cost of the new project. If, on the other hand, golf course operations are terminated by reason of continuing operating losses, for example, without a formal plan for a "higher and better use," the $700,000 of development and construction costs would be written off to the extent the total unrecovered costs of $1 million exceed the estimated net realizable value of the property in its present state.

Cost of Sales

33. Costs applicable to real estate sold should be charged to cost of sales when the related sales revenue is recorded in operating results.[8] Such costs include the allocated portion of costs incurred plus accruals for estimated costs to be incurred for the real estate sold.

TRANSITION

34. The accounting standards division recommends the application of the provisions of this statement prospectively for fiscal years, and interim periods in such fiscal years, beginning after December 24, 1979. Earlier application is encouraged for fiscal years beginning before December 25, 1979, for which financial statements have not been issued. Costs capitalized or deferred in accordance with generally accepted accounting principles in years before the fiscal year for which the provisions of this statement are first applied should not be written off even though such costs do not qualify for capitalization or deferral according to the conclusions in this statement. Such capitalized costs should be reallocated to components of real estate projects in accordance with the conclusions in this statement unless it is not practicable to do so. Changes in estimates and reallocations made to conform with the conclusions in this statement should be accounted for as revisions of estimates as discussed in paragraphs 28 and 29 of this statement. Costs charged to expense in years before the fiscal year for which the provisions of this statement are first applied should not be capitalized or deferred to conform to the conclusions in this statement.

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[7] Net realizable value (NRV) is the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining selling price), holding, and disposal. The division has prepared an issues paper regarding NRV to be presented to the FASB for its consideration.

[8] For a discussion of circumstances under which recognition of revenue is deferred because of the seller's obligation for future performance, see note 6.